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Reforming English Company Law to Promote Sustainable Companies

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Introduction

This article sets out a suggested set of regulatory changes which would steer companies incorporated under English law to take greater account of the impact of their activities on the sustainability of the eco-system. However, it should be stated at the outset that, for a number of reasons, it is very unlikely that these changes will be implemented any time soon. Firstly, the long Company Law Review process which preceded the introduction of the Companies Act 2006 demonstrated that policy-makers are convinced by the argument that the primary goal of company law is to ensure accountability of managers to shareholders. This conclusion is justified by neoliberal ideology, and any other goal, however desirable, will be rejected if it threatens to undermine this primary purpose.[1] Secondly, policy-makers view English company law as a source of comparative advantage, with businesses from more regulatory jurisdictions keen to incorporate in England, at least in part because of its light touch, facilitative regime. Thirdly, all the main political parties would view as undesirable any change to company which calls into question shareholder primacy and so threatens the price of shares. Accordingly, if English company law is to be reformed to promote sustainable companies, the impetus would probably have to come from the European Union.

Changes to Company Law

Reform of Section 172 Companies Act 2006

English company law is largely facilitative, which means that it would not be particularly difficult from a technical point of view to implement the necessary changes. Section 172 of the Companies Act 2006, which was introduced as part of the 2006 reforms, requires company directors to promote the success of the company for the benefit of its members as a whole, whilst taking account of a number of 'stakeholder' considerations, including 'the consequences of any decision in the long term'.[2] This did not make major substantive changes to the previous common law position, which equated the 'interests of the company' with the shareholder interest, albeit that it was down to the directors to determine the time frame for, and riskiness of, shareholder returns. Essentially, directors have very broad latitude to take business decisions, provided they can articulate a vaguely credible argument that any decision would be likely to produce shareholder returns in the future.

[1] So for example, a 'substantial majority' of respondents to the Company Law Review consultation 'strongly opposed' allowing directors to give stakeholder interests priority over shareholders because this would impose an 'uncontrolled' 'distributive economic role' on directors in 'allocating the benefits and burdens of management of the company's resources'. See *Modern Company Law: Developing the Framework* (Company Law Review Steering Group, March 2000), 2.12.

[2] Indeed the Government White Paper, *Company Law Reform* (Cm 6456), states at 16 that 'the success of the company for the benefit of its members… can only be achieved by taking due account of longer term performance and wider interests'.

The business judgement rule which is implicit in English common law means that the courts do not police that discretion in a meaningful way, and there are no recent examples of judicial intervention. Since managerial discretion extends to both the riskiness of decisions and the time frame for shareholder returns, a decision will only be open to challenge if no reasonable director could have considered the decision capable of producing returns for shareholders. Whilst it would be possible to include 'the environmental sustainability of any decision' among the 'stakeholder' considerations, and perhaps desirable in terms of drawing directors' attention to its importance, it is not strictly necessary as the list contained in section 172 is non-exhaustive. In law, at least, directors of companies incorporated in England and Wales are already entitled to take account of environmental sustainability, provided they can articulate a business case for this (i.e., that it would promote the success of the company for the benefit of its members as a whole, whether in the short- or long-term). The obstacle to directors using their discretion in this way is found not in law but in the broader corporate governance system, as discussed below.

Reform beyond the business case

The more difficult issue for company law is whether directors should be permitted to take account of sustainability where there is no business case for doing so. This issue has been little discussed, with the academic literature focused on discussions of 'win-win scenarios', 'creation of shared value', and so on. Yet it seems likely that in many, if not most cases, making business operations more sustainable will not increase shareholder returns because, for the most part, customers, employees and others who affect the corporation's bottom line do not take account of this in their buying and selling decisions.[3] Since this is a market failure which undermines a public good, namely the sustainability of the earth's ecosystem, then regulatory intervention can be justified in principle, provided its discounted benefits exceed its discounted costs.[4] Leaving aside the difficult question of the appropriate rate of discount to apply,[5] it is arguable that the costs of ecosystem collapse are of a different order and so are not comparable with the benefits to shareholders, employees and consumers of business as usual, because those costs would bring life to an end.[6] If this argument is accepted, then greater creativity in the use of core company law tools will be required. Beate Sjåfjell has argued that a duty should be imposed on company directors to consider environmental sustainability alongside the interests of the company.[7] Here, I will argue that company directors should be required to establish procedures to identify and internalise environmental and social externalities arising from the company's activities and from its supply chain. This duty would apply irrespective of whether the directors can articulate a business case for internalisation of the externality in question.

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[3] D. Vogel, The Market for Virtue (Brookings Institution Press 2006), Chapter Three.

[4] R. Coase, 'The Problem of Social Cost' 3 *Journal of Law and Economics* 1.

[5] For a helpful discussion of this, see J. Quiggin, 'Discount Rates and Sustainability' 24 International Journal of Social Economics 65.

[6] See D. W. Bromley, 'Environmental Regulations and the Problem of Sustainability: Moving beyond "Market Failure"' (2007) 63 *Ecological Economics* 676 and A. Vatn and D. W. Bromley, 'Choices without Prices without Apologies' (1994) 26 *Journal of Environmental Economics and Management* 129.

[7] See B. Sjåfjell, 'Towards a Sustainable Development: Internalising Externalities in Norwegian Company Law', *International and Comparative Corporate Law Journal* (2011) Volume 8, Issue 1, pp. 103-136, available at http://papers.ssrn.com/abstract=1712796; *Towards a Sustainable European Company Law* (Kluwer 2009), 105-110.

The duty would be discharged by compliance with a two stage process. In the first stage, directors would conduct due diligence into the social and environmental costs of the company's activities. Where the incidence and extent of costs is controversial, directors would meet with groups of stakeholders who consider themselves affected, as well as with experts, in order to construct the facts about particular externalities.[8] In the second stage, directors would identify appropriate ways of internalising the externalities identified in the first stage. This second stage might be left to managerial discretion, subject to an obligation to publish accounts detailing the facts about externalities and the company's response to them. However, some form of regulatory or stakeholder oversight of decisions about internalisation might make this process more effective.[9]

Initially this approach would only apply to companies above a certain size. Larger companies with dispersed shareholders are less likely than smaller companies to be constrained by social norms in the places where their decisions produce effects.[10] They are also more likely to have significant operations and contractual relationships which cross national boundaries. This regulatory scheme offers a number of advantages. The law does not have to identify particular stakeholders, externalities or solutions in advance, allowing it to cope with the complexities of modern, transnationally integrated systems of production. Moreover, by operating at the level of company decision-making, the scheme would be able to deal with transnational externalities which currently lie beyond the scope of traditional regulation. Finally, fears of managerial unaccountability can be dismissed. Just as the business judgement rule does not lead to unaccountability because discretion is exercised within a governance structure, accountability can be ensured under this proposal by those concerned assessing whether companies internalise the externalities they identify.

This approach finds echoes in the European Commission's recent restatement of its approach to corporate social responsibility.[11] However, the argument being made here, namely that social costs cannot be left to market pressure and concerns for reputation, and that companies should be required by law to identify and take responsibility for them contradicts mainstream assumptions about the function of company law. The generally accepted view in Anglo-American company law scholarship is that company law should focus on the 'agency' relationship between directors and shareholders (and, occasionally creditors), whilst specific regulation should be introduced externally to prevent social and environmental cost,[12] at least where bargaining can be shown to be unfeasible.

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[8] This proposal draws on the work of French sociologist Michel Callon on 'hybrid fora', meetings between affected groups and experts in which facts about externalities are produced through temporary consensus, even in the face of scientific uncertainty: see for example M. Callon, 'An Essay on Framing and Overflowing: Economic Externalities Revisited by Sociology' in M. Callon (ed), *The Laws of the Markets* (OUP 1998). For a more detailed discussion, see A. Johnston, 'Governing Externalities: The Potential of Reflexive Corporate Social Responsibility', Centre for Business Research, University of Cambridge, Working Paper No. 436; and A. Johnston, 'Facing up to Social Cost: The Real Meaning of Corporate Social Responsibility' (2011) 20(1) Griffith Law Review 221. See also B. Sjåfjell, 'Internalizing Externalities in EU law: Why Neither Corporate Governance Nor Corporate Social Responsibility Provides the Answers', (2010) 40(4) George Washington International Law Review 977 (available at http://papers.ssrn.com/abstract=1139584).

[9] See for example Bavoso's contribution in this issue.

[10] See for example the discussion of the 'Community Control Gap' in Marccus and Partners' Report prepared for the European Commission entitled *The Takeover Bids Directive Assessment Report* at 79-80.

[11] See European Commission, *A Renewed EU strategy 2011-14 for Corporate Social Responsibility* (COM(2011) 681 final, 25.10.2011.

[12] For a more detailed account of this argument, see M. Moore, *Corporate Governance in the Shadow of the State* (Hart 2013), 64. According to this logic, environmental protection should be achieved through rules

This flawed argument assumes that regulation is capable of solving any market failure, and then relies on that assumption to justify the narrow scope of company law. Yet modern legal scholarship is full of examples and explanations of regulatory failure. If regulation cannot effectively correct a market failure, whether because of transnational externalities, uncertainty or the complexity of production chains and their effects, then the narrow scope contended for company law cannot be justified so simply.[13] Debunking this argument is an essential first step on the road to a broader system of company law which takes account of sustainability issues and social cost more generally. However, as the next section will show, company law reform alone will be insufficient to promote more sustainable corporate decision-making.

Changes to Corporate Governance

We saw above that English company law is mostly facilitative, and that directors already have discretion to take account of sustainability considerations, subject only to the very loose constraint of needing to make a plausible business case for doing so. In order to limit this discretion and 'improve accountability', directors are currently given strong incentives to maximise short-term shareholder value. The result is that they do not exercise their legal discretion to take account of sustainability or externalities. The two main sources of these incentives are the system of takeover regulation and the 'high powered incentives' of executive pay, reform of which will now be discussed.

Reform of takeover regulation

Since 1968, takeover regulation in the UK has prohibited boards from taking measures that frustrate takeover bids, and that prohibition was subsequently included in the 2004 European Takeover Directive (albeit that it was made optional in order to achieve political agreement on the directive). The aim of the prohibition is to create a market for corporate control, in which a bidder can acquire control over a company by purchasing a majority of its shares, and replace incumbent managers with their own nominees. The effect is to incentivise managers to focus on keeping the share price high enough to deter would-be bidders. This is commonly justified on the basis that the share price reflects the creation of shareholder value, and assuming effective external regulation, also reflects the public good. However, as mentioned above, there are serious doubts about the possibility of designing conventional external regulation which will adequately protect environmental and social interests. Moreover, it is far from settled that the market for corporate control even increases aggregate shareholder wealth, given the losses suffered by shareholders in bidder corporations.[14]

For the purposes of this short article, it suffices to note that the prohibition on frustrating action produces effects on corporate governance that extend far beyond the takeover context: it effectively truncates management's discretion to take account of considerations such as sustainability, which

aimed at all economic actors, not only corporations, even if the vast majority of economic activity is carried on through corporations.

[13] In fact it requires an argument that the benefits of narrow company law (in terms of managerial accountability to shareholders) exceed its costs (in terms of externalities).

[14] See, for example, R. Roll, 'The Hubris Hypothesis of Corporate Takeovers' (1986) 59 *Journal of Business* 197.

will only be reflected in the share price in the long term, if at all, and forces them to focus on actions which will deliver increases in the share price in the short term, such as buybacks of shares.

If the reforms proposed here are implemented, and managerial discretion is to function as a means to the end of greater sustainability, then it will be essential to remove the prohibition on frustrating action. As noted, the Takeover Directive permits individual Member States not to impose the prohibition, and some have taken this course of action. However, it seems very unlikely that the UK would take this option of its own accord.

Reform of executive pay

The other main barrier to directors using their discretion to take greater account of sustainability in their decision-making is the practice of executive pay. Executives are remunerated with stock options and other forms of variable pay which have the effect of aligning their interests with those of shareholders as expressed in the current share price. The justification for this is, once again, that increasing the share price can be equated with the public good, assuming that this is done within the law. Yet, regulation does not require sustainable economic activity, and it seems unlikely that it would be effective were it to try. Also, there is little reason to believe that the share price of companies reflects the long-term sustainability of company activities. However, most policy debates steer clear of these issues, casting the problem of executive pay as one of temporality; this is merely a 'contracting problem', and companies simply need to identify the right contract terms to achieve an acceptable alignment of executive self-interest with the long-term shareholder interest.[15] However, those contract terms have not yet been found, and there is little reason to believe that they will ever be found. In the meantime, corporate governance provides distinctly short-termist incentives, and sustainability remains excluded from decision-making.

This short critique suggests that, if companies are going to take greater account of sustainability in their decision-making, executive pay needs to be regulated. It would be possible to prohibit stock options altogether, as the Commission canvassed in 2010.[16] Alternatively, and perhaps more realistically, variable pay could be capped at the level of fixed pay, as has recently become law in relation to financial institutions,[17] where short-term incentives contributed to the near-destruction of the financial system. Attempts to use soft law to encourage a longer-term approach to remuneration have failed; stock options need to be prohibited or capped before short-term incentives also result in the destruction of the eco-system.

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[15] See for example Commission Recommendation on Remuneration Policies in the Financial Services Sector (2009/384/EC), which states that remuneration policy should be in line with 'long-term interests of the financial undertaking, such as sustainable growth prospects' (para 3.2), as though a recommendation will enable this contractual objective to be achieved.

[16] European Commission, *Green Paper on Corporate Governance in Financial Institutions and Remuneration Policies* (COM(2010) 284 final, 2.6.2010) at 18

[17] See Art 94 of Directive 2013/36/EU (Capital Requirements Directive IV); for an economic justification of the cap, see A. Johnston, 'Preventing the Next Financial Crisis? Regulating Bankers' Pay in Europe' (2014) 41(1) *Journal of Law and Society* 6.

Conclusion

This short article has argued that there are serious ideological and political barriers to the notion that English company law should be used as a means of governing companies so that they take account of sustainability considerations. However, if reforms were to be introduced, they would be need both at the level of core company law and at the level of the broader corporate governance system. Ultimately, given the scientific consensus on the threat of climate change, it is hoped that this short article makes at least a minor contribution to the debate about how companies can be held responsible for the externalities their operations create.